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Securities Arbitration: A Need for Continued Reform

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Abstract

Arbitration as an alternative to the vagaries of litigating through the judicial system has worked well in practice, as well as in theory, for many kinds of disputes - in labor-management, commercial, and maritime.

KEYWORDS: exchange, Dean Witter, overreaching

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I. INTRODUCTION

Arbitration as an alternative to the vagaries of litigating through the judicial system has worked well in practice, as well as in theory, for many kinds of disputes—in labor-management, commercial, and maritime. The process is generally less frustrating, less expensive, and less time-consuming than conventional litigation. However, securities broker/customer arbitrations have not enjoyed the same high degree of success as other types of commercial arbitration, which generally are between two industry participants that are on relatively equal footing.

Generally, investors are at a disadvantage with large brokerage firms that often are members of the self-regulating organizations (SROs) which typically conduct the arbitration proceedings. Brokerage firms also are intimately familiar with the arbitration process, whereas investors rarely understand this process prior to arbitrating an actual dispute. As such, the investing public perceives forced arbitration of their disputes with brokers as inherently unfair, which undermines the integrity of the financial markets and serves to impede the flow of capital upon which our economic system depends. Even if it could be successfully argued that securities arbitration in its current form is fair in the majority of cases, the fact that it is perceived as being unfair by the investing public should be reason enough to consider continued reform in order to instill investor confidence, a prime concern since the stockmarket crash of 1929. The public's apprehension is further justified by the fact that securities industry arbitrators are not required to follow laws and write no opinions for the scrutiny of any court or the appointed watchdog of the federal securities laws, the Securities and Exchange Commission (the SEC or the Commission).[1] Consequently, the

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1. Margo E. Reder, *Securities Law and Arbitration: The Enforceability of Predispute Arbitration Clauses in Broker-Customer Agreements*, 1990 COLUM. BUS. L. REV. 91, 96 (1990). Vacating decisions only upon a showing of "manifest disregard" for the law means the arbitrators do not have to strictly comply with the securities laws. *Id.*; *see also* 9 U.S.C.A. §§ 10, 11 (West 1981 & Supp. 1988) (judicial interpretations resulted in the development of the "manifest disregard" standard); Wilko v. Swan, 346 U.S. 427, 436 (1953) *overruled by* Rodriguez De Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989) (5-4 decision); David A. Lipton, *The Standard on Which Arbitrators Base Their Decisions: The SROs Must Decide*, 16 SEC. REG. L.J. 3, 8, 13-14 (1988) (securities arbitration awards typically made without any explanation and manifest disregard standard allows arbitrators great latitude in decision making); *cf.* Diana B. Henriques, *When Naivete Meets Wall Street*, N.Y. TIMES, Dec. 3, 1989, at § 6 (quoting Craig Goettsch, Superintendant of Securities of Iowa and Chairman of the Arbitration Review Panel of the North American Securities Administrators Association, as stating that the industry opposes written opinions because it opens door to appeals); Nathaniel C. Nash, *New SEC Chief Defines Goals*, N.Y. TIMES, Oct.

public cannot receive assurance that securities arbitrationis adequate. Under such circumstances the public's negative view is unlikely to wane.

This is not to say that securities arbitration could not be made to work to the satisfaction of both parties, not just to the satisfaction of the securities industry, as it now stands. For instance, a meaningful choice could be required in all pre-dispute arbitration agreements (PDAAs) to allow investors the option of selecting an alternative arbitration forum other than a SRO of which the opposing securities firm is likely to be a member or have significant ties, e.g., the American Arbitration Association (AAA). Arbitrators also should be required to write at least cursory opinions consisting of their basic findings of fact and the rules of law they apply in making their decisions and awards, so that the public can understand the reasoning behind their decisions. Losing customers could also be allowed to seek a judicial or Commission review based on these written opinions, if reasonable grounds could be shown that the securities laws were applied incorrectly by the arbitrators, or the arbitrators lacked sufficient evidence to support the findings of fact. Arbitrators should also be required to consider punitive and RICO (Racketeer Influenced and Corrupt Organization Act)[2] damages if a judicial remedy would permit such damages, whether or not such damages are provided for in the arbitration agreement.

Securities arbitration may well work better than expensive, time-consuming litigation through the court system, but it is far from ideal in its current form, and should be improved. Many of the claims investors bring against their brokers involve relatively small amounts of only a few thousand dollars.[3] These claimants obviously are better off arbitrating their disputes where time and expense are less of an obstacle to recovery. The securities industry also benefits, as its cost of litigation is substantially reduced.[4] Therefore, arbitration should be promoted, but changes are

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25, 1989, at D1, D10 (key to maintaining investor confidence is for SEC to enforce securities laws) [hereinafter N.Y. TIMES]; Letter from Securities Industry Conference on Arbitration to Richard G. Ketchum, Director of SEC Market Regulation Division 6-7 (Dec. 14, 1987) (on file with the SEC) (SICA agrees with SEC recommendation for maintenance of case results, but then criticizes plan as lacking in utility and misleading in nature).

2. 18 U.S.C.A. §§ 1961-1968 (West 1981 & Supp. 1988) (provides for treble damages for prohibited racketeering activities which typically involve charges of mail and wire fraud in securities cases).

3. *Surveying Public Award Results*, 3 SEC. ARB. COMMENTATOR (Nos. 3 & 4) 1, 2 (Mar. & Apr. 1990) [hereinafter *Survey*].

4. *See* John L. Di Fiore, *Problems in Alternative Dispute Resolution: Arbitration Agreements as Contracts of Adhesion in Consumer Securities Disputes*, 93 COM. L.J. 259 (1988).

necessary to ensure substantial fairness and justice, and to instill greater investor confidence in the securities industry, which would benefit securities firms more in the long run than any changes might cost them in the short run through more frequent or higher customer awards.

II. The Merits of Alternative Dispute Resolution

> Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser–in fees, expenses, and waste of time. As a peacemaker the lawyer has a superior opportunity of being a good man . . . . Never stir up litigation. A worse man can scarcely be found than one who does this.[5]

No one involved in the judicial process can deny that litigation can be frustrating, expensive, and time consuming. Frequently, it is unrewarding for litigants, as fees, expenses, and consumption of time often outweigh any award. Judge Learned Hand once said, "I must say that, as a litigant, I should dread a lawsuit beyond almost anything else short of sickness and death."[6] In complex commercial litigation, such as in the IBM and AT&T antitrust cases,[7] discovery and litigation can take many years and consume tens of millions of dollars. An avid enthusiast for alternative dispute resolution, former Chief Justice Warren E. Burger commented, "I cannot emphasize too strongly to those in business and industry—and especially to lawyers—that every private contract of real consequence to the parties ought to be treated as a 'candidate' for binding private arbitration."[8]

"Society cannot and should not rely exclusively on the courts for the resolution of disputes."[9] Alternative dispute resolution mechanisms can be

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5. Abraham Lincoln *quoted in* Warren E. Burger, *Using Arbitration to Achieve Justice*, 40 ARB. J., Dec. 1985, at 3, 4.

6. Learned Hand, *Deficiencies of Trials to Reach the Heart of the Matter*, *in* 3 LECTURES ON LEGAL TOPICS, ASS'N BAR CITY OF N.Y. 89, 105 (1926).

7. The U.S. government instituted antitrust actions against AT&T and IBM in the mid-1970s. Both actions were tied up at the trial level until the early 1980's when the government dropped its action against IBM, and AT&T agreed to break up its local operating companies into separate independent concerns.

8. Burger, *supra* note 5, at 6.

9. NATIONAL INSTITUTE FOR DISPUTE RESOLUTION, REPORT OF THE AD HOC PANEL ON DISPUTE RESOLUTION & PUBLIC POLICY (1983), *reprinted in* L. KANOWITZ, ALTERNATIVE DISPUTE RESOLUTION 3 (1986). Support for this project was provided by the Federal Justice Research Program through Grant No. 83-NI-AX-0002 to the National Institute for Dispute

less expensive, faster, less intimidating to the parties, more sensitive to their concerns, and more responsive to the underlying problem.[10] The parties also have a better chance of preserving the relationship and fulfilling their need to retain control over the dispute by not handing it over to the intricacies of the legal system.[11]

Americans are litigious by nature.[12] This results from an open and free society that allows wrongs to be remedied. As technological advances continue to complicate our lives, new causes of action arise. As a result, our court system is overloaded, not only because of an ever-increasing case load, but because cases are becoming evermore complex, resulting in trials that last months or even years. Alternative dispute resolution can serve to reduce this burden.

III. Enforceability of Pre-dispute Arbitration Agreements

In 1925, Congress enacted the Federal Arbitration Act[13] (FAA) to place arbitration agreements on the same footing as other private contracts and reduce costly litigation.[14] Section two of the FAA declares that such agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract," while sections three and four provide for a stay of judicial proceedings and a court order to compel arbitration where an agreement in writing for such arbitration exists between the parties. The FAA was necessary to overturn earlier case law which was hostile to the concept of arbitration. A party can only avoid arbitration on the limited grounds of fraud or overreaching by the party extracting the agreement, or by contrary congressional command.[15]

Pre-dispute arbitration agreements between securities brokers and investors usually permit customers to bring claims only before a SRO. Usually this means a choice between the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), or the

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Resolution. *Id.*

10. *Id.*

11. *Id.*

12. *See* 1 ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA (H. Reeve trans. 1961). "Scarcely any question arises in the United States which does not become, sooner or later, a subject of judicial debate." *Id.* at 330.

13. 9 U.S.C.A. §§ 1-14 (West 1981 & Supp. 1992).

14. *See* H.R. No. 96, 68th Cong., 1st Sess. 1, 2 (1924).

15. *See* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987) (5-4 decision).

American Stock Exchange(AMEX). Only a few of the PDAAs allow for the option of bringing claims before the independent American Arbitration Association.[16] Securities disputes usually involve claims of broker fraud and misrepresentation, unauthorized trading, and racketeering activity, as well as other deceptive and unfair trade practices, which result in losses in the customer's account.[17] The Securities Act of 1933[18] and the Securities Exchange Act of 1934[19] were enacted by Congress to provide remedies for wrongs committed by brokers against customers in an attempt to instill confidence in the securities markets and to prevent any repeat of the 1929 stockmarket crash.[20] For instance, section 12(2) of the 1933 Act[21] provides for civil liability against sellers of securities who knowingly make misstatements of, or omit, material facts in order to induce investor purchases of securities. Section 10(b) of the 1934 Act[22] makes it unlawful for any person to employ any manipulative or deceptive device in connection with the purchase or sale of securities. How these statutory rights are to be enforced has been debated in the courts for over half a century.

As a precondition to trading in securities, the customer must sign the brokerage firm's standardized agreement, which invariably includes a predispute arbitration clause. This clause provides that any controversy between the parties relating to the account shall be settled by binding arbitration, usually before one of the SROs. Traditionally, the courts have not interpreted such agreements to preclude the customer's right to pursue congressionally created causes of action in court, despite the all-inclusive language of the PDAA.

A. *Arbitrability of Claims Under the Securities and Exchange Acts*

1. *Wilko v. Swan*

The Supreme Court first addressed the issue of arbitrability of claims under the Securities and Exchange Acts in 1953, in *Wilko v. Swan*.[23]

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16. Reder, *supra* note 1, at 95-96.

17. *See* David E. Robbins, *Securities Arbitration: Preparation and Presentation*, 42 ARB. J., June 1987, at 2, 6.

18. 15 U.S.C. §§ 77a-77z (1981).

19. 15 U.S.C. §§ 78a-78ll (1981).

20. *See generally* 1 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1993 & SECURITIES EXCHANGE ACT OF 1934 (1973).

21. 15 U.S.C. § 77l (1981).

22. 15 U.S.C. § 78j (1981).

23. 346 U.S. 427 (1953), *overruled by* Rodriguez De Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989) (5-4 decision).

Wilko brought an action against a securities brokerage firm in district court to recover damages under section 12(2) of the 1933 Act.[24] The broker moved to stay the judicial proceedings and compel arbitration in accordance with the terms of an arbitration agreement signed by Wilko.[25] The district court denied the stay based on the advantageous court remedy afforded investors under the Securities Act.[26] A divided court of appeals reversed, stating that the Act did not prohibit arbitration of such controversies.[27] The issue before the Supreme Court was whether the agreement to arbitrate future controversies of all claims was void as to statutory claims under the Securities Act.[28]

The Supreme Court found that Congress passed the Securities Act of 1933 to protect investors from fraudulent sales of securities, and specifically created section 12(2) to allow recovery for misrepresentation.[29] The Court also found that section 14 of the Act[30] prevented the enforcement of the arbitration agreement, as it was the intent of Congress that the right to a judicial forum provided for under the Act could not be waived.[31] The Court stated that arbitral forums lacked suitable oversight and safeguards to ensure a fair and just resolution of the dispute.[32]

Construed to the narrow facts of the case, this holding applied only to alleged violations of the 1933 Act. While not addressed by the Court, a strong argument could have been made that *Wilko* extended to the 1934 Act, as the 1934 Act was *in pari materia* of the 1933 Act, which was enacted to provide some stability to the stockmarket during the depression years following the crash of 1929. As such, the 1934 Act was intended to finish the job started in 1933, and the two Acts should be read *in pari materia*, with section 14 of the 1933 Act extended to the latter. The Court's decision in *Wilko* may well have been the correct one. Importantly, the Securities Act was passed eight years following the FAA. Congress was well aware of its presence and specifically put language in the 1933 Act that gave the

24. *Id.* at 428.
25. *Id.* at 429.
26. *Id.* at 430.
27. *Id.*
28. *Wilko*, 346 U.S. at 430.
29. *Id.* at 431.
30. Section 14 of the 1933 Act states, "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n (1981).
31. *Wilko*, 346 U.S. at 436-37 (arbitrator's power almost unlimited while judicial review extremely limited).
32. *Id.* at 433-34.

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district courts of the United States concurrent jurisdiction with state and territorial courts regarding offenses and violations under the Act.[33] Section 14 would seem to make this provision non-waivable.

United States courts of appeals interpreted *Wilko* to apply to the 1934 Act, as well. In *Dickinson v. Heinold Securities, Inc.*,[34] the Seventh Circuit held that a cause of action under section 10(b) of the Securities Exchange Act of 1934 was non-arbitrable regardless of the agreement between the parties, based on the Seventh Circuit's previous holding in *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[35] which relied upon the Supreme Court's holding in *Wilko*. The circuit courts generally held *Wilko* to mean that *all* alleged violations of *any* federal securities laws were non-arbitrable.[36]

2. *Dean Witter Reynolds, Inc. v. Byrd*

The Supreme Court remained silent, however, on the issue of arbitrability of alleged violations of the 1934 Act until its 1985 decision in *Dean Witter Reynolds, Inc. v. Byrd.*[37] The issue was not directly brought before the Court because Dean Witter never raised the issue of arbitrability of alleged violations of the 1934 Act.[38] Byrd, an investor, had brought a complaint against Dean Witter raising both federal securities claims based on sections 10(b), 15C, and 20 of the 1934 Act, and pendent state claims.[39] The state claims were admittedly arbitrable, but Byrd sought to have them

33. Section 22(a) of the 1933 Act states, "[t]he district courts of the United States . . . shall have jurisdiction of offenses and violations under this subchapter . . . concurrent with State and Territorial courts . . . . " 15 U.S.C. § 77v (1981).

34. 661 F.2d 638 (7th Cir. 1981).

35. 558 F.2d 831 (7th Cir. 1977).

36. Kehr v. Smith Barney, Harris Upham & Co., 736 F.2d 1283 (9th Cir. 1984); Kershaw v. Dean Witter Reynolds, Inc., 734 F.2d 1327 (9th Cir. 1984); Liskey v. Oppenheimer & Co., 717 F.2d 314 (6th Cir. 1983); Sawyer v. Raymond, James & Assoc., Inc., 642 F.2d 791 (5th Cir. 1981); DeLancie v. Birr, Wilson & Co., 648 F.2d 1255 (9th Cir. 1981); Mansback v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore, 590 F.2d 823 (10th Cir. 1978); Sibley v. Tandy Corp., 543 F.2d 540 (5th Cir. 1976), *cert. denied,* 434 U.S. 824 (1977); Alleggert v. Perot, 548 F.2d 432 (2d Cir. 1977), *cert. denied,* 432 U.S. 910 (1977); Greater Continental Corp. v. Schechter, 422 F.2d 1100 (2d Cir. 1970); *see also* Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 733 F.2d 59 (8th Cir. 1984); Belke v. Merrill Lynch, Pierce, Fenner & Smith, 693 F.2d 1023 (11th Cir. 1982); Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 538 F.2d 532 (3d Cir. 1976), *cert. denied,* 429 U.S. 1010 (1976).

37. 470 U.S. 213 (1985).

38. *Id.* at 215.

39. *Id.* at 214.

tried along with the federal securities claims based on the principle of pendent jurisdiction.[40] The district court refused to grant Dean Witter's motion to compel arbitration of the state law claims independent of the federal securities claims.[41] The Supreme Court found unpersuasive the arguments advanced in support of the district court's ruling, however, and reversed the decision of the court of appeals insofar as it upheld the district court's denial of Dean Witter's motion to compel arbitration of the state law claims.[42]

The important language in *Byrd* can be found in footnote one.[43] In that footnote, the Court hinted at the inapplicability of *Wilko* to a claim arising under section 10(b) of the Securities Exchange Act of 1934. The court noted that the provisions of the 1933 and 1934 Acts differ, and that, unlike section 12(2) of the 1933 Act, section 10(b) of the 1934 Act does not expressly give rise to a private cause of action. Dean Witter and *amici* representing the securities industry urged the Court to resolve the applicability of *Wilko* to claims under the 1934 Act, but the Court declined to do so because the issue was not properly before the Court.

However, the Court did not have long to wait before the issue was properly presented. Shortly after *Byrd*, the Second Circuit reaffirmed its pre-*Byrd* holding of non-arbitrability in *McMahon v. Shearson/American Express, Inc.*[44] Shearson appealed and the Supreme Court granted certiorari.

3. *Shearson/American Express, Inc. v. McMahon*[45]

McMahon was the first case in which the Supreme Court directly considered the arbitrability of alleged violations under the 1934 Act. The Second Circuit reasoned that clear circuit precedent, the similarity of the

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40. *Id.*

41. *Id.* at 215-16.

42. *Dean Witter Reynolds, Inc.*, 470 U.S. at 223-24.

43. *Id.* at 215 n.1.

44. 788 F.2d 94 (2d Cir. 1986), *cert. granted*, 479 U.S. 812 (1986). Following *Byrd*, but before the Supreme Court's decision in *McMahon*, the Eighth Circuit refused to follow the precedent set by other circuit courts that alleged violations under the 1934 Act were non-arbitrable. *See* Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 795 F.2d 1393 (8th Cir. 1986). *But see* Conover v. Dean Witter Reynolds, Inc., 794 F.2d 520 (9th Cir. 1986) (continuing to hold that claims arising under § 10(b) of the 1934 Act were non-arbitrable); Preston v. Kruezer, 641 F. Supp. 1163 (N.D. Ill. 1986) (rule 10b-5 claims as well as RICO claims non-arbitrable). See sources cited *supra* note 36 for previous circuit court decisions holding that all alleged violations of any federal securities laws were non-arbitrable.

45. 482 U.S. 220 (1987) (5-4 decision).

1933 and 1934 Acts, and "strong public policy concerns" precluded arbitration of such claims.[46] Relying on the customer agreements that contained a PDAA, Shearson moved to compel arbitration of the claims under section three of the FAA.[47] The District Court held that under the Court's decision in *Byrd*, and the "strong national policy favoring the enforcement of arbitration agreements," the Securities Exchange Act claims were arbitrable under the terms of the agreements.[48] The Court of Appeals reversed, but acknowledged that *Byrd* had "cast some doubt on the applicability of *Wilko* to claims under [section] 10(b)" of the 1934 Act.[49]

In a 5-4 decision, the Supreme Court stated that the FAA was "intended to revers[e] centuries of judicial hostility to arbitration agreements by, plac[ing] [them] 'upon the same footing as other contracts.'"[50] The Court continued, saying that the FAA established a federal policy favoring arbitration which required rigorous enforcement of such agreements.[51] The Court had no qualms in applying this reasoning to claims founded on statutory rights.[52] "Absent a well-founded claim that an arbitration agreement resulted from the sort of fraud or excessive economic power that 'would provide grounds for the revocation of any contract,' the Arbitration Act 'provides no basis for disfavoring agreements to arbitrate statutory claims.'"[53] "The Arbitration Act, standing alone, therefore mandates enforcement of agreements to arbitrate statutory claims . . . by agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute . . . ."[54] As such, absent any explicit congressional language in the 1934 Act, the Court held that agreements to arbitrate Exchange Act claims were enforceable in accord with the explicit provisions of the FAA.[55] The Court applied this same reasoning to the McMahons' RICO claims, finding them arbitrable as well.[56]

The dissent, led by Justice Blackmun, remained suspicious of securities arbitration, stating that "[b]oth the Securities Act of 1933 and the Securities

46. *Id.* at 225.
47. *Id.* at 223.
48. *Id.* at 224.
49. *Id.* at 225.
50. *McMahon*, 482 U.S. at 225-26 (citations omitted).
51. *Id.* at 226.
52. *Id.*
53. *Id.* (citation omitted).
54. *Id.* at 229.
55. *McMahon*, 482 U.S. at 226-27, 238.
56. *Id.* at 242.

Exchange Act of 1934 were enacted to protect investors.[57] However, "[t]he Court . . . leaves such claims to the arbitral forum of the securities industry at a time when the industry's abuses towards investors are more apparent than ever."[58] The dissent seemed to be saying that the majority was putting the "pirates in pinstripe" on Wall Street back at the helm of the ship, something that Congress had set out to undo in the 1933 and 1934 Acts. The dissent's apprehension of securities arbitration may have been overdone, but the perception of public hostility was well grounded. "[T]he investor has the impression, frequently justified, that his claims are being judged by a forum comprised of individuals sympathetic to the securities industry . . . ."[59] "The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be *some* truth to the investors' belief that the securities industry has an advantage . . . ."[60] However, in *Rodriguez De Quijas v. Shearson/American Express, Inc.*,[61] the majority of the Court solidified its backing of securities arbitration.

4. *Rodriguez De Quijas v. Shearson/American Express, Inc.*

The *McMahon* Court went to considerable lengths to differentiate its decision from *Wilko*. The dissent was correct in its assessment, however, that the majority had effectively overruled *Wilko*. In *Rodriguez De Quijas*, not long after the *McMahon* decision, a divided Court officially overruled *Wilko*. Perhaps justifiably fearful of a flood of securities litigation following the stockmarket crash of October, 1987,[62] the Court held that all securities claims, including those under the 1933 Act, are arbitrable under PDAAs.[63]

In *Rodriguez De Quijas*, the petitioner alleged violations of both the

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57. *Id.*
58. *Id.* at 243 (Blackmun, J., dissenting).
59. *Id.* at 260.
60. *McMahon*, 482 U.S. at 261.
61. 490 U.S. 477 (1989) (5-4 decision).
62. In an effort to bring claims for judicial resolution, investors alleged violations of the Securities Act which were out of reach of the Court's holding in *McMahon*. *See, e.g.*, Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 841 F.2d 508 (3d Cir. 1988); Chang v. Lin, 824 F.2d 219 (2d Cir. 1987); Ketchum v. Bloodstock, 685 F. Supp. 768 (D. Kan. 1988). These cases have been overruled by *Rodriguez De Quijas*. *But see* Noble v. Drexel, Burnham Lambert, Inc., 823 F.2d 849, 850 (5th Cir. 1987) (formal overruling of *Wilko* imminent); Ryan v. Liss, Tenner & Goldberg Sec. Corp., 683 F. Supp. 480, 494 (D.N.J. 1988) (claims under Securities Act arbitrable).
63. *Rodriguez De Quijas*, 490 U.S. at 479-82.

1933 and 1934 Acts, as well as of state law.[64] Relying on *Wilko*, the District Court had ordered all claims, save those raised under the 1933 Act, to be submitted to arbitration.[65] The court of appeals, however, reversed on the issue of arbitrability of alleged violations under the 1933 Act, because the Supreme Court had essentially reduced *Wilko* to "obsolescence" in *McMahon*.[66] After following *Wilko* for nearly four decades, the Supreme Court declared that "[i]t has been recognized that *Wilko* was not obviously correct . . . ."[67] The Court found that the language prohibiting waiver in the 1933 Act could easily have been read to relate to substantive provisions of the Act without including the remedy provisions, and that the *Wilko* Court had essentially decided the way it had because of "the old judicial hostility to arbitration."[68] "To the extent that *Wilko* rested on suspicion of arbitration . . . it has fallen far out of step with our (the Court's) current strong endorsement of the federal statutes favoring this method of resolving disputes . . . ."[69]

The majority also placed great weight on the SEC's ability to ensure fairness in the arbitral process.[70] However, as Justice Blackmun pointed out in his dissenting opinion in *McMahon*, the Commission's oversight consists of nothing more than a general review of SRO arbitration rules and does not include any review of specific arbitration proceedings for misapplication of securities laws or for any indication of fairness to investors.[71] It is unlikely any such review is a meaningful possibility, so long as arbitrators are not required to give reasons for their decisions.

If there were any doubts as to the direction of the Supreme Court after *McMahon*, they were laid to rest after *Rodriguez De Quijas*. Although both cases were decided by a 5-4 vote, none of the Justices in the majority in *McMahon* changed positions in *Rodriguez De Quijas*.[72] In the interim period between the two cases, Justice Kennedy, who voted with the majority in *Rodriguez De Quijas*, replaced Justice Powell, who voted with the majority in *McMahon*. Both Justice Brennan and Justice Marshall were

64. *Id.* at 478-79.
65. *Id.* at 479.
66. *Id.*
67. *Id.* at 480.
68. *Rodriguez De Quijas*, 490 U.S. at 480.
69. *Id.* at 481.
70. *Id.* at 482-83.
71. 482 U.S. at 265.
72. The *McMahon* majority included Chief Justice Rehnquist and Justices O'Connor, Powell, Scalia, and White, while the majority in *Rodrigues De Quijas* consisted of Chief Justice Rehnquist and Justices Kennedy, O'Connor, Scalia, and White.

among the dissenters. Consequently, it appears that the Supreme Court is unlikely to change its position with respect to arbitration of securities disputes in the near future.

B. *Avoidance Based on Fraudulent Inducement or Overreaching*

For the courts and Congress to allow private remedies under the Securities and Exchange Acts, and then permit the securities industry unilaterally to force PDAAs on customers as a precondition to investing may seem to undermine the system's fairness and curtail congressionally-created and judicially-recognized rights.[73] Under section two of the FAA, however, arbitration agreements are valid, irrevocable, and enforceable except upon such grounds as exist at law or in equity for the revocation of any contract. Recognizing a strong federal policy favoring arbitration, the Supreme Court in *McMahon* interpreted this to mean that a contract to arbitrate must be rigorously enforced and that a party could only avoid arbitration on the limited grounds of fraud or overreaching by the party extracting the agreement, or by contrary congressional command.[74]

In *McMahon* and *Rodriguez De Quijas*, the Court determined that there was no such congressional command in either the Exchange Act or the Securities Act (despite its explicit language to the contrary).[75] This seems to limit challenges to enforcement of PDAAs to claims of fraud or of broker overreaching in forcing unconscionable contracts of adhesion on customers.

1. Claiming Fraudulent Inducement as a Means of Avoiding Arbitration

The Supreme Court has emphasized that "[i]n the absence of any express provision excluding a particular grievance from arbitration . . . only the most forceful evidence of a purpose to exclude the claim from arbitration can prevail."[76] In *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*,[77] the Court refused to rescind an arbitration clause, despite a claim of fraud in the inducement of the contract.[78] The Court approved circuit court decisions holding that arbitration clauses are

73. Reder, *supra* note 1, at 117.
74. 482 U.S. at 226.
75. *See* sources cited *supra* notes 30 & 33.
76. United Steelworkers of Am. v. Warrior & Gulf Navigation Co., 363 U.S. 574, 584-85 (1960).
77. 388 U.S. 395 (1967).
78. *Id.* at 406.

"separable" from the contracts in which they are embedded and, where no claim of fraud is directed at the arbitration clause itself, that claims of fraudulent inducement are arbitrable.[79] Reconfirming *Prima Paint*, the Court stated in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*[80] that "[t]he Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration . . . ."[81] To hold differently would permit a party, "upon the mere cry of fraud in the inducement . . . [to frustrate] the very purpose sought to be achieved by the agreement to arbitrate . . . ."[82] In a broadly-worded arbitration clause, all grievances even remotely related to the contract are arbitrable.[83]

2. PDAAs as Unconscionable Contracts of Adhesion

The Supreme Court has not precluded claims that securities arbitration agreements are unconscionable contracts of adhesion, but the lower federal and state courts have tended to reject such claims. "The purpose of the unconscionability doctrine is to prevent unfair surprise and oppression."[84] When a party of little bargaining power, and hence very little choice in the terms of the contract, signs a commercially unreasonable contract with little or no understanding of its terms, courts may withhold enforcement based on unconscionability.[85] Unconscionability will be found where: 1) there is

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79. *Id.* at 402. For a thorough discussion of this issue see Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak St., 673 P.2d 251 (Cal. 1983).

80. 460 U.S. 1 (1983).

81. *Id.* at 24-25.

82. Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402, 410 (2d Cir. 1959).

83. *See* Bird v. Shearson Lehman/Am. Express, Inc., No. 90-7688 (2d Cir. 1991) (LEXIS, Genfed library, US App file); *see also* Raytheon Co. v. Automated Business Sys., Inc., 882 F.2d 6 (1st Cir. 1989) (claims for punitive damages are arbitrable even if not provided for in PDAA); Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334 (7th Cir. 1984) (fraud, breach of fiduciary duty, gross negligence, negligence, all are arbitrable); Smoky Greenhaw Cotton Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 720 F.2d 1446 (5th Cir. 1983) (claims under the Commodity Exchange Act arbitrable); Sauer-Getriebe KG v. White Hydralics, Inc., 715 F.2d 348 (7th Cir. 1983) (under broadly-worded arbitration clause, even validity of contract itself is subject to arbitration); Fuller v. Guthrie, 565 F.2d 259 (2d Cir. 1977) (arbitrable unless wholly unexpected tortious behavior is far beyond the intended scope of the performance contract's arbitration clause).

84. Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984) (citing FMC Fin. Corp. v. Murphree, 632 F.2d 413, 420 (5th Cir. 1980); Leasing Serv. Corp. v. Broetje, 545 F. Supp. 362, 366 (S.D.N.Y. 1982)).

85. *Id.*; Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449-50 (D.C. Cir. 1965); Preston v. Kruezer, 641 F. Supp. 1163, 1172 (N.D. Ill. 1986); *Leasing Serv. Corp.*,

an "absence of meaningful choice on the part of one of the parties" and 2) the challenged "contract terms are unreasonably favorable to the other party."[86]

To satisfy the first part of this two-part test, the arbitration agreement must be a contract of adhesion. The common threads of adhesive contracts are that they are: 1) standardized contracts, 2) imposed and drafted by the party of superior bargaining strength, and 3) who offers the adhering party the limited choice of accepting or rejecting the contract as written.[87] Since virtually all brokerage firms now require customers to sign a standardized customer agreement that includes a pre-dispute arbitration clause as a precondition to investing,[88] and investors are generally in a weaker bargaining position,[89] such agreements are fairly classified as contracts of adhesion.[90]

Simply because a contract is one of adhesion, however, does not make it unenforceable.[91] The fact that one party had little bargaining power is

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545 F. Supp. at 366; Contract Buyers League v. F & F Inv., 300 F. Supp. 210, 227 (N.D. Ill. 1969), *aff'd*, 420 F.2d 1191 (7th Cir. 1969), *cert. denied*, 400 U.S. 821 (1970).

86. *Williams*, 350 F.2d at 449 (two-part test set forth by Judge Wright); *see also* Hume v. United States, 132 U.S. 406, 411 (1889) (unconscionable if "no man in his senses, not under delusion, would make on the one hand, and as no honest and fair man would accept on the other").

87. Graham v. Scissor-Tail, Inc., 623 P.2d 165, 171 (Cal. 1981); Neal v. State Farm Ins. Co., 188 Cal. App. 2d 690, 694 (Cal. Ct. App. 1961).

88. The SEC considers it typical for brokerage firms to include PDAAs in customer agreements and require customers to sign these agreements at the time of opening a securities trading account. *See* SEC. EXCH. ACT RELEASE NO. 15984 n.4 (July 2, 1979), *reprinted in* 17 SEC DOCKET 1167, 1169 n.4.

89. *See* Stanbury & Klein, *The Arbitration of Investor-Broker Disputes*, 35 ARB. J. (No. 3) 30, 37 (1980).

90. *See* Finkle & Ross v. A.G. Beker Paribus Inc., 622 F. Supp. 1505, 1511 (S.D.N.Y. 1985) (investors faced with accepting standardized brokerage contracts with arbitration clauses or being excluded from the securities market, such clauses come within the adhesion doctrine); *see also* Di Fiore, *supra* note 4, at 270-71.

91. One theory for not making such contracts unenforceable is as follows:

> Through advance knowledge on the part of the enterprise offering the contract that its relationship with each individual consumer or offeree will be uniform, standard and fixed, the device of form contracts introduces a degree of efficiency, simplicity, and stability. When such contracts are used widely, the savings in cost and energy can be substantial. An additional benefit is that goods and services which are covered by these contracts are put within the reach of the general public, whose sheer size might prohibit widespread distribution if the necessary contractual relationships had to be individualized. Transactional costs, and therefore the possible prices of these goods and services, are reduced. In short, form contracts appear to be necessary concomitant of a sophisticated,

not in itself sufficient to declare the PDAA provision unconscionable.[92] The second part of the two-part test must be met—the terms must be "unreasonably favorable" to the other party. In this regard, courts have considered whether: 1) the arbitration provision could reasonably be thought to fall within the normal expectations of the adhering party, *or* 2) whether the terms of the provision were so one-sided that enforcement against the adhering party would be unduly oppressive.[93] These two distinctions have been respectively termed "procedural unconscionability" and "substantive unconscionability."[94]

a. *Procedural Unconscionability*

Procedural unconscionability concerns the process and circumstances under which the parties entered into the PDAA.[95] The broker may use high-pressure tactics, downplay the importance of the provision, fail to explain its significance, or use other deceptive practices, especially where the customer is obviously unable to reasonably comprehend the import of such a clause.[96] This broker overreaching is better described as the fraudulent inducement of the arbitration clause.

In the past, some courts have refused to enforce PDAAs based on procedural unconscionability.[97] This was before the Supreme Court's strong pro-arbitration decision in *Rodriguez De Quijas,* however, and while other courts enforced PDAAs virtually no matter how they were procured.[98] Given the Supreme Court's strong backing for arbitration of

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mass-consumption economy.
Graham, 623 P.2d at 171 n.15.

92. T.A. Moynahan Properties Inc. v. Lancaster Village Coop., Inc., 496 F.2d 1114, 1119 (7th Cir. 1974).

93. *Graham,* 623 P.2d at 172-73.

94. *See* Di Fiore, *supra* note 4, at 269; Arthur A. Leff, *Unconscionability and the Code—The Emperor's New Clause,* 115 U. PA. L. REV. 485, 487 (1967).

95. Di Fiore, *supra* note 4, at 269-70.

96. *See* State v. Wolowitz, 468 N.Y.S.2d 131, 145 (N.Y. App. Div. 1983).

97. *E.g.,* Woodyard v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 640 F. Supp. 760 (S.D. Tex. 1986) (neophyte investor who admittedly did not understand arbitration was required by broker to sign arbitration agreement sometime after trading began in order to continue receiving investment income).

98. Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,733 F.2d 58, 59 (8th Cir. 1984) (nothing unfair about arbitration clause); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Benton, 467 So. 2d 311 (Fla. 5th Dist. Ct. App. 1985) (faith in fairness of arbitration compels enforcement even though investor did not read or speak English and could not have comprehended terms of agreement); *see also* Coleman v. Prudential Bache Sec. Inc., 802

securities disputes, the latter view will likely prevail. With PDAAs so widely used by the securities industry, and with this so widely known by investors, no one can argue any longer that such clauses in customer agreements are beyond the reasonable expectations of any investor.[99]

b. Substantive Unconscionability

Substantive unconscionability, the last remaining hope for investors to avoid forced arbitration, involves adhesive contracts that contain overly oppressive terms favoring the broker. The terms of the vast majority of securities arbitration agreements, however, do little more than bind both parties to arbitrate future disputes relating to the account before one of the named arbitration forums in the agreement.[100] Courts generally do not find such clauses that merely change the forum, while preserving the customer's substantive rights, to be unconscionable.[101] The Supreme Court made it clear in *McMahon* that by agreeing to arbitrate a statutory claim a party does not forgo any substantive rights.[102]

This view by the courts does not take into account the concerns raised in Justice Blackmun's dissenting opinion in *McMahon*.[103] The real substantive unconscionability cannot be found between the four corners of the arbitration agreement. Aggrieved investors forced into this situation can do little more than voice their fears to the courts that the broker will be favored if the case is arbitrated before a panel of the broker's fellows. Courts have summarily dismissed such claims, however, as "unfounded speculation."[104]

F.2d 1350 (11th Cir. 1986) (following *Surman*); Hall v. Prudential Bache Sec., Inc., 662 F. Supp. 468 (C.D. Ca. 1987) (following *Surman*).

99. *See* Marx v. Dean Witter Reynolds, Inc., No. 85-669-RG, Fed. Sec. L. Rep. (CCH) ¶ 92,311 (C.D. Cal. 1985) (arbitration provisions quite common and reasonably to be anticipated); Anderson v. Paine Webber Jackson & Curtis, Fed. Sec. L. Rep. (CCH) ¶ 92,446 (C.D. Cal. 1985) (arbitration provision reasonably within the expectation of both parties).

100. *See* Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334, 336 n.2 (7th Cir. 1984) (giving an example of a typical arbitration clause).

101. *See* Driscoll v. Smith Barney, Harris Upham & Co., 815 F.2d 655, 658 (11th Cir. 1987) (arbitration clause only changes forum where investor must go to assert rights); Preston v. Kruezer, 641 F. Supp. 1163, 1172-73 (N.D. Ill. 1986) (because of strong federal policy favoring arbitration, arbitration cannot be against public policy; arbitration clause only changes forum in which investors air complaints, so provision to arbitrate does not "unreasonably favor" the broker).

102. *McMahon*, 482 U.S. at 229.

103. *See supra* text accompanying notes 57-59.

104. *Preston*, 641 F. Supp. at 1173; *cf.* Parr v. Superior Court, 139 Cal. App. 3d 440,

Essentially, once an investor signs a customer agreement that contains a PDAA, all future disputes relating to the account will have to be arbitrated predominately on the broker's terms. It does not matter under what circumstances the agreement was extracted, short of the broker holding a gun to the investor's head (but even this may be an arbitrable issue). With the perceived unfairness of forced securities industry arbitration, the rift between customers and brokers will not abate unless the perceived inequities are rectified.

IV. How Fair Has Securities Industry Arbitration Been?

The securities industry would have customers believe that "industry-run" arbitrations are fair. The industry has repeatedly pointed out that investors win more than half of the arbitration cases,[105] and that customers have received a greater percentage of their original claims and higher awards in arbitration, compared with litigation.[106] Since May, 1989, the SROs have been required to make customer awards public, which has shown that customers receive awards in about half the cases.[107] Generally, a fifty-fifty split in arbitration has been considered an indication of arbitrator impartiality, but "(t)o 'keep score' of arbitrators with such a simplistic classification represents an extremely naive view of neutrality."[108]

What is a win? Considering that the dollar amounts of awards in securities arbitrations have averaged less than thirty cents per dollar of the customer's initial claim (based only on compensatory damages),[109] a

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447 (Cal. Ct. App. 1983) (presumption of unconscionability in NYSE arbitration rebutted if a majority of arbitrators are from outside the securities industry); Hope v. Superior Court, 122 Cal. App. 3d 147, 154-55 (Cal. Ct. App. 1981), *cert. denied sub nom.* Shearson, Hayden, Stone, Inc. v. Hope, 456 U.S. 910 (1982) (presumptive institutional bias in favor of NYSE members in NYSE arbitration could be remedied by allowing neutral person to select panel). *But cf.* Lewis v. Prudential Bache Sec., Inc., 179 Cal. App. 3d 935 (Cal. Ct. App. 1986) (forcing investor to arbitrate solely before the NYSE of which defendant is a member unduly favors broker; arbitration appropriate if proper forum found).

105. *See, e.g.*, Edward Giltenan, *Wall Street's Other Arb's*, FORBES, Mar. 20, 1989, at 196-97.

106. Reder, *supra* note 1, at 114.

107. N.Y. TIMES, *supra* note 1, at D1, D10.

108. David A. Ditts & Clarence R. Deitsch, *Arbitration Win/Loss Rates as a Measure of Arbitration Neutrality*, 44 ARB. J., Sept. 1989, at 42, 43.

109. *See Survey*, *supra* note 3, at 2; *see also* Stephen P. Bedell et al., *The McMahon Mandate: Compulsory Arbitration of Securities and RICO Claims*, 19 LOY. U. CHI. L.J. 1, 9 (1987) (citing a 1985 AAA survey of 40 cases involving securities arbitration of which 27

customer win does not seem to amount to much.

Reported 1989 Customer/Claimant Arbitrations[110]

	No. of Awards	Percent Customer Wins	Percent Recovered by Winning Customer	Percent Compensatory Claim Recovered on All Initial Claims[111]
NYSE	206	52%	40%	21%
NASD	297	58%	60%	35%
All SROs	519	56%	50%	28%
AAA	146	59%	N/A	N/A

Reported 1990 Customer/Claimant Arbitrations[112]

	No. of Awards	Percent Customer Wins	Percent Recovered by Winning Customer	Percent Compensatory Claim Recovered on All Initial Claims
NYSE	263	55%	35%	19%
NASD	956	59%	41%	24%
All SROs	1263	59%	40%	24%
AAA	172	58%	57%	33%

The above figures indicate that while customer win ratios remained

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resulted in customer awards). When punitive claims are included the percentage of recovery declines dramatically, as punitive damages usually are not awarded.

110. *See Survey*, *supra* note 3, at 3-4; *AAA vs. SROs: The "Fairness Factor" – Is There a Difference*, 3 SEC. ARB. COMMENTATOR (Nos. 6 & 7) 1, 3 (June & July 1990).

111. To calculate the "Percent Compensatory Claim Recovered on All Initial Claims," multiply "Percent Customer Wins" by the "Percent Recovered by Winning Customer."

112. *Survey of Public Awards Results*, 4 SEC. ARB. COMMENTATOR (No. 5) 1, 2, 6-7 (Sept. 1991) (1990 figures are the most recent available, SAC expects to publish arbitration results for 1991 around mid-1993).

fairly constant in 1990 with 1989, customer recovery ratios at SRO arbitrations dropped markedly. this was despite an expected improvement by industry-watchers that was supposed to occur due to the new requirements for public disclosure awards. The figures also show that investors fared much better arbitrating claims before the AAA, compared with SROs, receiving substantially higher percentage awards in 1990, particularly compared with the NYSE. In fact, customer claimants recovered seventy-four percent more arbitrating before AAA, compared to NYSE arbitrations and were thirty-eight percent better off than arbitrating before NASD. This may be the result of differences in the arbitrator selection processes, reflecting the stronger ties of brokerage firms to the SROs, particularly with the NYSE.

Under the AAA securities arbitration rules, when the claim is for less than $20,000 only one arbitrator is chosen by the parties to decide the dispute, but the arbitrator may not be affiliated with the securities industry.[113] For larger claims, three arbitrators are chosen by the parties with no more than one having affiliation with the securities industry.[114] For a comparison with SROs, in an arbitration before the NYSE the arbitration panel is selected by the NYSE Director of Arbitration, who also appoints the chairman of the panel.[115] A panel consists of either three or five arbitrators, depending on the size of the claim, a majority of whom "shall not be from the securities industry."[116] This does not mean that the appointed arbitrators that are not from the securities industry cannot be affiliated with the securities industry in some way. Moreover, the securities industry partially funds the SROs,[117] although less of the SRO's revenues are being derived directly from member firms.[118]

What this proves is very little. It may be that a fifty percent win ratio paying out 30 cents on the dollar is quite generous to customers based on the facts of the individual cases. Unfortunately, there is no way of telling

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113. George H. Friedman, *Arbitrating Your Case Under the Securities Rules of the AAA*, 43 ARB. J., June 1988, at 23, 28-29 (affiliation is defined as persons who have been directly or indirectly employed by or acted as counselors, consultants, or advisors to any securities organization or affiliate within the past five years).

114. *Id.*

115. NYSE ARBITRATION RULES, Art. XI § 2, Rule 607 (identical to the NASD CODE OF ARBITRATION PROCEDURE, §§ 4, 19).

116. *Id.* (emphasis added).

117. Diana B. Henriques, *Market Place; Single Arbitration Agency Sought*, N.Y. TIMES, Dec. 21, 1989, at D8.

118. Interview with Richard Rider, Publisher of SEC. ARB. COMMENTATOR (Aug. 12, 1991).

without the written opinions of arbitrators. Under the present state of securities arbitration, our intuition may be the only guiding light. The industry's actions do not seem to support its contention that investors fare better in industry arbitration. With the securities industry feverishly fighting to uphold PDAAs at every turn, and disputing customers desperately trying in vain to avoid the consequence, it would seem that investors are the ones getting the short end of the stick, as Justice Blackmun pointed out in his dissenting opinion in *McMahon*.

If the true intent of the securities industry has been to provide a cost-effective, yet fair means of customer dispute resolution, that notion was brought into question by *Cowen & Co. v. Anderson*.[119] In this Court of Appeals of New York case, Cowen & Co. sought to stay arbitration of a customer dispute before the AAA and force arbitration before a SRO.[120] The securities firm lost at the trial level and through both appeals levels, despite support from the Securities Industry Association (SIA) as *amicus curiae*.[121] Essentially, because of a hidden flaw in the drafting of the PDAA, the customer could elect to arbitrate before the AAA, even though on its surface the PDAA seemed to limit the customer's choices to the NYSE, the NASD, or the AMEX.

The agreement stated that any controversy arising out of, or relating to, the customer's account shall be settled by arbitration in accordance with the rules of the NYSE, the NASD, or the AMEX, as the customer may elect.[122] Fortunately for the customer, the rules of the AMEX included the "AMEX Window"[123] which authorized the election of the AAA.[124] Cowen never intended the AAA to be an option, and had it drafted the PDAA to limit arbitration only before the three SROs, rather than in accordance with their rules, the customer would not have had the AAA as an option.[125] But even before this case was decided by the Court of Appeals of New York, the AMEX promptly removed the clause from its constitution so that investors could no longer take their disputes to the

119. 558 N.E.2d 27 (N.Y. 1990).
120. *Id.* at 27-28.
121. *Id.* at 28.
122. *Id.* at 28 n.2.
123. AMEX CONST. art. VIII, § 2(c).
124. *Cowen & Co.*, 558 N.E.2d at 28. Federal district courts have refused to interpret "rules of the AMEX" to encompass the "AMEX Window." *See* Bear Stearns & Co. v. N.H. Karol & Assocs., 728 F. Supp. 499, 500, 503-04 (N.D. Ill. 1989); Paine Webber, Inc. v. Astrella, No. 89-2268 (D.N.J. Sept. 6, 1989).
125. *Cowen & Co.*, 558 N.E.2d at 29.

independent AAA.[126] The securities industry prefer industry arbitration to the independent AAA. The above data seems to bear this out. Importantly, most PDAAs restrict arbitration forums to SROs.

V. Improving Public Perception

A. *State Legislative Action*

In *Securities Industry Ass'n v. Connolly*,[127] the SIA along with ten brokerage firms sought a declaration that new Massachusetts legislation was unconstitutional because it conflicted with the provisions and policies of the FAA.[128] The new regulations: 1) barred brokerage firms from requiring individuals to enter PDAAs as a non-negotiable condition to opening an account, 2) required brokers to inform prospective customers of this prohibition, and 3) demanded full written disclosure of the legal effect of pre-dispute arbitration contracts.[129] (The Commonwealth of Massachusetts enacted this legislation after the Supreme Court's decision in *McMahon*.) The district court granted declaratory and injunctive relief and the First Circuit affirmed, based on preemption under the supremacy clause of article VI of the United States Constitution."[130] The Supreme Court denied certiorari.

Somehow the First Circuit found on-point, prohibitive language in the "ordinary meaning" of section two of the FAA,[131] where no such explicit language exists. Section two of the FAA only serves to place written arbitration agreements on the same footing as other enforceable contracts.[132] It says nothing about how those contracts are to come into

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126. N.Y. Times, *supra* note 1, at D1, D10.
127. 883 F.2d 1114 (1st Cir. 1989), *cert. denied*, 495 U.S. 956 (1990).
128. *Id.* at 1116-17.
129. *Id.* at 1117.
130. *Id.*
131. *Id.* at 1118.
132. Section 2 of the FAA states:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2 (1989).

existence. The court read section two beyond its "ordinary meaning." This reflects the current obsession of the judiciary that all securities disputes be settled by arbitration rather than in the courts.

On the surface, the Massachusetts regulations were not in direct conflict with the FAA. Massachusetts apparently was only trying to provide its citizens with a true choice of voluntarily entering into a PDAA contract fully understanding the consequences. Maybe the court actually thought that the regulations would raise false apprehensions among investors with regard to entering into PDAAs and that other states would follow the Massachusetts lead. "[T]he Regulations, by requiring what is not generally required to enter contracts in the Commonwealth, e.g., certain negotiations, explanations, and disclosures, inhibit a party's willingness to create an arbitration contract . . . ."[133] Investors already had apprehensions regarding securities industry arbitration, however, so that could not have been the reason. More likely, the court feared that when confronted with a true choice investors would opt out en masse from PDAAs. (It would be a simple task to open a new account with another brokerage firm, excluding the PDAA clause, and transfer all the funds and securities from the old account.) This obviously would not comport with the Supreme Court's determination that arbitration is to be preferred in securities disputes.[134] The court in *Connolly* stated that any "limitary approach would seemingly defeat the very aim of the Act, allowing states to revivify the ancient jurisdictional antagonism toward arbitration by cloaking it in regulatory garb. At the very least, such enmity, howsoever manifested in state law, is preempted."[135]

A frontal assault by state legislatures obviously will not work and is likely to be counterproductive. "The legal standard is whether the Regulations take their meaning from the fact that a contract to arbitrate is at issue, or frustrate arbitration, or provide a defense to it. If so, the federal policy requires . . . finding the Regulation preempted."[136] State legislatures should keep in mind that securities arbitration can be made fair and can offer significant benefits to the investing public. Instead of passing legislation that is dead upon enactment, states should consider regulations

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133. 883 F.2d at 1123.

134. *See* Webb v. R. Rowland & Co., 800 F.2d 803, 906 (8th Cir. 1986) (court struck down Missouri's effort to require highlighting of arbitration clauses in contracts); Collins Radio Co. v. Ex-Cell-O Corp., 467 F.2d 995, 997 (8th Cir. 1972) (court refused to honor state requirement that arbitration agreements bear an attorney's acknowledgement attesting that all parties had been informed of the agreement's effects).

135. 883 F.2d at 1120.

136. *Id.* at 1123.

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that would promote arbitration by requiring openness and fairness in the arbitration process, which might not be objected to by the federal courts.

B. *Congressional Action*

Although some members strongly oppose the Court's rulings in *McMahon* and *Rodriguez De Quijas*, Congress has not exercised its power to override these decisions. Following the Court's ruling in *McMahon*, Representative Frederick C. Boucher (D. VA.) introduced a bill, entitled the Securities Arbitration Reform Act of 1988.[137] The bill would have invalidated all existing, as well as future PDAAs that were not entered into on a "truly" voluntary basis.[138] Brokerage firms would not have been allowed to require customers to sign a PDAA as a precondition to opening an account, thereby preserving rights to a judicial forum.[139] This bill, however, has not become law. Representative Edward J. Markey, (D. Mass.), a co-sponsor of the bill and Chairman of the Subcommittee on Telecommunications and Finance of the Energy and Commerce Committee, called the Court's ruling in *Rodriguez De Quijas* a blow to the rights of investors who are forced into a "Faustian bargain" of giving up the right to litigate in order to gain the right to invest,[140] and while Congress continued to hold hearings on this matter,[141] no action was taken. The fact remains that passing a bill which would allow customers to litigate disputes against brokers is difficult, due to the securities industry's well-financed and powerful lobby in Washington. Moreover, passing such legislation may be counterproductive. Representative Boucher did not give up, however. In May, 1991, he introduced another bill, entitled the Investment Advisors Disclosure and Enforcement Act of 1991, this time attacking the abuses of investment advisors and their use of forced PDAAs on customers.[142] The bill would have permitted private remedies for the enforcement of the Investment Advisors Act of 1940[143] and specifically proposed that these newly-created judicial rights and remedies may not be waived by any agreement relating to arbitration.[144] This bill also has not become law.

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137. 134 CONG. REC. E2,233 (daily ed. June 30, 1988).
138. *Id.*
139. *Id.*
140. Linda Greenhouse, *Supreme Court Backs Brokers on Arbitration*, N.Y. TIMES, May 16, 1989, at D2.
141. Reder, *supra* note 1, at 109.
142. H.R. 2412, 102d Cong., 1st Sess. (1991).
143. 17 C.F.R. §§ 275.0-2 to .206(4)-4 (1991).
144. H.R. 2412, 102d Cong., 1st Sess. (1991).

Securities firms, as well as investment advisors, are likely to vigorously oppose any bill seeking to change the status qou.

C. *SEC Action*

The SEC has "broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights."[145] The Commission has the power to "abrogate, add to, and delete from" any SRO rule to further the objectives of the securities laws.[146] In *McMahon*, the Court concluded that "the SEC has sufficient statutory authority to ensure that arbitration is adequate . . . ."[147] This conclusion was reiterated in *Rodriguez De Quijas*.[148] Apparently the Commission could act in any manner it deems fit with the full backing of Congress and the Supreme Court, with the likely exception of banning PDAAs from the securities industry.

In this regard, the SEC could be particularly effective in correcting the perceived inequities confronting brokerage firm customers. It could act much more quickly than Congress and much more surely than state legislatures. The Commission has taken some measures in the recent past to improve the arbitration process. In May, 1989, the SEC approved a number of SRO rule changes that formalized the arbitration process.[149] The new rules affected accounts opened after September, 1989, and required that arbitration clauses be highlighted and clearly explained, which was made a requirement over strong objections from the securities industry.[150]

The SEC's actions thus far have been aimed at defusing the controversy

145. *McMahon*, 482 U.S. at 233-34; *see* Securities Exchange Act of 1934, Registration, Responsibilities, and Oversight of Self-Regulatory Organizations, 15 U.S.C. § 78s (1981).

146. 15 U.S.C. § 78s(c).

147. 482 U.S. at 238. *But see supra* note 72 and accompanying text (discussing lack of review of arbitration proceedings by SEC).

148. 490 U.S at 480.

149. *See* Paul Duke, Jr., *SEC Rules on Investor-Broker Disputes*, WALL ST. J., May 11, 1989, § 3 (the rules are aimed at defusing controversy surrounding PDAAs).

150. *See, e.g.*, Letter from John M. Liftin, Senior Vice President and General Counsel, Kidder Peabody & Co., to Richard A. Grasso, NYSE President and CEO (Oct. 6, 1988) (on file with the NYSE) (Kidder Peabody alleged that customer initialling of arbitration clauses to signal awareness and agreement would be too costly and time consuming and would foster litigation); Letter from Jeffrey B. Lane, Executive Vice President, Shearson Lehman Hutton, to John J. Phelan, Jr., NYSE Chairman (Oct. 4, 1988) (on file with the NYSE) (Shearson Lehman Hutton opposes initialling requirement because it places undue emphasis on arbitration clause and encourages needless litigation).

surrounding PDAAs,[151] rather than at equalizing broker-customer relations. If the SEC wants to resolve the problem, it could require that PDAAs allow investors the option of selecting at least one independent arbitration forum that owes no allegiance to the securities industry. The SEC could also require arbitrators to write brief opinions consisting of their basic findings of fact and the rules of law they apply in making their decisions and awards. This requirement is supported by the Supreme Court's statement that "a party does not forgo the substantive rights afforded" by agreeing to arbitrate.[152]

D. *A Suggested Reform*

What is most troubling about *Rodriguez* is its judicial activism. The dissent points out that *Wilko*, having stood as precedent for three and one half decades had acquired a meaning "as clear as if the judicial gloss had been drafted by the Congress itself."[153] If *Rodriguez* is judicial legislation, the Court should finish the job and lay down sensible limitations on predispute arbitration. However, if the Court is not willing to finish the job that it started, Congress or the Commission should take up the task.[154]

The Commission should amend its rules so that all investors would have the following rights:

1. *A right to select a neutral arbitration forum.*

The Commission should require that all predispute arbitration agreements provide that the arbitration should be done only by arbitrators on a list approved by the Commission. If the present industry arbitrations are fair, then the industry would lose nothing by such a proposal. An individual investor would always be free to agree to an industry arbitration,

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151. Duke, *supra* note 149, at C1.
152. *Shearson/Am. Express, Inc.*, 482 U.S. at 229.
153. *Rodriguez De Quijas*, 490 U.S. at 486.
154. Indeed, in *McMahon*, the Court pointed out that the Commission has the authority, that it lacked when *Wilko* was decided, to regulate predispute arbitration.

> In 1953, when *Wilko* was decided, the Commission had only limited authority over the rules governing self-regulatory organizations (SROs)—the national securities exchanges and registered securities associations—and this authority appears not to have included any authority at all over their arbitration rules. Since the 1975 amendments to Sec. 19 of the Exchange Act, however, the Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs.

McMahon, 482 U.S. at 233 (citation omitted).

provided such agreement was made after the dispute developed. The appearance of fairness is just as important as actual fairness. This measure alone would help to restore confidence in the securities industry.

2. *A right to a written opinion by the arbitrators; with findings of fact and conclusions of law.*

Arbitration without written opinions, or with only cursory opinions makes any judicial review meaningless. In securities arbitrations, the law is far more complex than in ordinary arbitrations, and errors in applying the law are far more likely unless there is some method of ascertaining that the arbitrators have done so correctly.

3. *All arbitrator's opinions would be filed with the Commission and would be a matter of public record.*

Unless the records of arbitration are easily accessible, it is impossible for the public or interested consumer groups to determine whether securities arbitrations are fair to the consumer.

4. *A right to have the proceedings recorded by a court reporter at the expense of the investor.*

An actual record of the proceedings is a potent method for protecting against misapplication of the law, but less expensive methods such as sound or video recordings could accomplish the same objective, so it would appear fair enough to require the investor to bear this cost, if he thinks it prudent.

5. *A right to a new arbitration if the arbitrators fail to apply the correct rules of law.*

This would appear to be the most prudent course, though on remand to a new board of arbitrators, the court or other reviewing authority should have the power to restrict the arbitrators to those with the necessary knowledge and experience. For example, in a very complex securities case, it might be appropriate to require that all of the arbitrators have law degrees as well as specific experience in securities law, assuming the complexity of the case results from legal as opposed to complex factual issues.

Presently, an investor's recourse after an arbitration is unsatisfactory. The grounds for vacating an award under the Federal Arbitration Act are extremely narrow. Although that policy may be rational for ordinary business litigation, it fails to take account of the special nature of securities litigation. The Securities Acts were adopted to change legal rules which were not protecting the average investor. Specifically, the common law action of deceit, commonly referred to as common law fraud, had proved to be an inadequate method of protecting investors. In promulgating the Securities Acts, Congress intended to remedy the inadequacies of common law fraud.[155] If the Supreme Court has removed the investor's judicial remedy, the arbitration substitute for it should be fashioned in such a manner that the remedy is meaningful. *Wilko* may be interpreted in two different ways. The majority opinion suggests that incorrect interpretations of the law by the arbitrators, as opposed to manifest disregard are not subject to judicial review.[156] Realistically, however, if the opinion of the arbitrators is summary in nature, there is no practical way to show either manifest disregard of an applicable legal standard or misinterpretation. Justice Frankfurter's dissent in *Wilko* states:

> Arbitrators may not disregard the law . . . . On this we are all agreed. It is suggested, however, that there is no effective way of assuring obedience by arbitrators to the governing law. But since their failure to observe this law . . . [would constitute grounds for vacating the award], appropriate means for judicial scrutiny must be implied, in the form of some record or opinion, however, informal, whereby such compliance will appear, or want of it will upset the award.[157]

Frankfurter's assumptions about the possibility of meaningful judicial review, based on some kind of record cannot be tested because empirical evidence does not exist. To the extent that Frankfurter's assumptions about some kind of record that would permit review are the foundation of his opinion, it suggests that a system without a system of meaningful review would not be supported by his reasoning, or indeed, the reasoning of the Supreme Court in *Rodriguez*. For the Commission to follow these suggestions would not undermine *Rodriguez*, but merely strengthen its reasoning.

VI. CONCLUSION

The fairness of our judicial system is predicated on openness, impartiality, and appellate review. Securities arbitration in its current repute fails in these important respects. Proponents argue that by signing a PDAA

155. LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION, 812-13.
156. Wilko v. Swan, 346 U.S. 427, 436 (1953).
157. *Id.* at 440.

an investor agrees to be bound by these inequities. It can hardly be said, however, that investors wilfully enter into such contracts. As such, continued reform of securities arbitration is necessary. The benefits of arbitration should not be jeopardized by the self-interests of the securities industry.

Human nature is to be fearful of the unknown. The non-disclosure of securities arbitration awards and proceedings breed public distrust of a system essentially administered by the securities industry. Under such circumstances, public suspicion of forced securities arbitration is understandable and warrants redress. Required disclosure of awards is an important first step in changing negative public opinion, but full disclosure of arbitration proceedings is imperative if the public is ever to perceive the process as being fair, irrespective of whether current arbitrations are conducted fairly.

It also is crucial that the investing public be offered a meaningful choice of selecting a forum that can be perceived as being impartial and free from the influence of the securities industry. Asking aggrieved investors to accept assurances from the opposition that it will conduct the proceedings fairly and deliver a just result is too much to ask of any party, irrespective of whether the results are actually fair.

There may be valid concerns with allowing a Commission or judicial review of arbitrator decisions as a matter of right. One of the main purposes of arbitrating is to expedite final resolution of disputes. Allowing for a review could reduce this important attribute of arbitration. As such, there must be attendant restrictions to reduce potential abuses. This could be accomplished by allowing only discretionary review. If securities arbitration is as fair as the securities industry purports, there would be few reviews granted. The main effect would be an improved public perception of fairness.

Importantly, none of the above proposals would defeat the aim of the FAA to place arbitration agreements on the same footing as other contracts. PDAAs would still be fully enforceable. The advantages of less expensive, less time-consuming dispute resolution would still be realized. The only significant difference would be increased fairness and a commensurate improvement in the public's perception of the securities arbitration process.